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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Respondent believes that petitioner's characterization of the question presented is superficial and does not accurately express the real issue in the case. The question accurately stated is whether respondent incurred amortizable original issue bond discount in issuing its $50 face amount, 18-year, 5% sinking fund debentures to its preferred stockholders in a one for one exchange for their preferred stock in respondent when at the time of the exchange in 1957 the fair market value of the preferred stock was $33 per share.

STATEMENT OF THE CASE

Petitioner's statement of the case de-emphasizes, at the expense of accuracy, the clear distinctions between the debentures and the preferred stock involved in the exchange, and consequently the true nature of the transaction which the Court of Appeals for the Tenth Circuit properly concluded created deductible bond discount.

On July 23, 1957, the preferred stockholders of respondent exchanged their preferred stock for respondent's $50 face amount, 18-year, 5% sinking fund debentures due in 1975. At the time of the exchange the fair market value of the preferred stock was $33 per share, a fact agreed upon by the parties in the Tax Court. The transaction was treated as a taxable exchange by the preferred stockholders as required by the United States Treasury Department in a ruling letter issued prior to the exchange which required the fair market value of the stock and the debentures to be used in determining the reportable amount of gain and loss to those stockholders. (Appendix B, p. 48).[1] Because the fair market value of the stock and debentures at the time of the exchange was relevant to petitioner for computing taxable gain and loss to the stockholders in 1957, respondent maintained that the fair market value ($33) also controlled the issue price of respondent's debentures and the amount of bond discount incurred.

The terms of the debentures appear in the debentures and in an Indenture dated July 1, 1957 between respondent and Fidelity-Philadelphia Trust Company, the Trustee under the Indenture. The debentures, as contrasted with

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1. All references to Appendices herein cited are references to Appendices found in petitioner's Petition for Writ of Certiorari.

the preferred stock, created a fixed obligation on the part of respondent to unconditionally pay interest of 5% and repay the principal at a fixed time in the future, regardless of the profits of respondent. Such a fixed obligation never existed prior to the exchange. (Appendix B, *supra* n.1, pp. 49-50).

A sinking fund was established pursuant to the Indenture in order to assure retirement of the debentures. Respondent was at all times on schedule in meeting the requirements of the sinking fund and never defaulted on any of the terms of the Indenture. (Appendix B, *supra* n.1, pp. 49-50). Since the commencement of this case, respondent has redeemed and retired all of the debentures, and consequently, no further deduction for the bond discount at issue in this case is being taken at this time nor will be taken in the future.

The preferred stock received by respondent, in exchange for the debentures, was retired and cancelled, upon the issuance of the debentures, by an entry on respondent's books debiting the capital account for preferred stock (a stockholders' equity account) and crediting the liability account for 18-year, 5% debentures (a long-term liability account). (Appendix B, *supra* n.1, p. 43). This accounting for the transaction reflected the very basic transformation which occurred in the capital structure of respondent. The debentureholder, a creditor, replaced the preferred stockholder, an owner. The unconditional obligation to pay the principal amount of the debentures at maturity plus the stated annual interest replaced the discretionary power in the respondent relative to dividend payments on the stock which depended upon the earnings of respondent. (Appendix B, *supra* n.1, pp. 43-44).

The financial status of respondent at the time of the exchange and the circumstances surrounding the issuance

of the debentures were typical of the circumstances which compel any corporation to issue debt securities at a discount. The 1957 exchange was, in fact, a transaction demanded by economic and business reality. The preferred stock in the market place was worth $33 a share. There were two years of dividend arrearages outstanding on the preferred stock. Further, respondent's operations, as reflected in its income statements, and its financial status, as reflected in its balance sheets, were in critically poor condition. (Appendix B, *supra* n.1, p. 43).

When respondent issued its debentures for the preferred stock, the amount received for the debentures, from its standpoint, clearly was the $33 market value of the preferred stock. The value of the preferred stock on the open market at the time of the exchange ($33) clearly determined the face amount and interest rate of the debentures which respondent was willing to issue and the preferred stockholders were willing to accept.

ARGUMENT

Respondent believes that petitioner has wholly failed to establish any grounds upon which review of this case by the Supreme Court of the United States is justified.

1. The Court of Appeals for the Tenth Circuit in reversing the United States Tax Court rendered an exhaustive opinion in which it directly pointed out that the Supreme Court had previously decided the basic and narrow issue involved in this case, and that consequently there was a lack of conflict among the courts. In noting this the court stated as follows:

> "It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and received therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3] [3. *Helvering* v. *Union Pacific Railroad Co.*, 293 U.S. 282 (1934)].
>
> "The reason for allowing the discount is that it represents the expense of borrowing. It serves 'the same function as stated interest'[4] [4. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57 (1965)] and 'represents a part of the cost of the borrowed capital.'[5] [5. *Helvering* v. *Union Pacific Railroad Co.*, 293 U.S. 282, 287 (1934)].
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> * * *

"We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount * * *." (Appendix B, *supra* n.1, 58, 59, 65).

These basic principles of the tax law, establishing the deductibility of bond discount as interest as pronounced by the Supreme Court, have been followed by the various courts of appeal without exception for many years.

The Petition for Certiorari wholly fails to point out the applicability of any principle of the tax law which dictates a method for determining whether bond discount exists in any given situation other than the basic rules set forth in the foregoing decisions of the Supreme Court. *United States* v. *Midland-Ross Corp., supra; Helvering* v. *Union Pacific Railroad Co., supra.*

Nevertheless, petitioner, in relying upon the decisions and analysis of the Court of Claims in certain bond discount cases arising out of railroad reorganizations, seems to be suggesting to the contrary and that a determination as to whether or not bond discount exists in a given case can be made without regard to the economic facts surrounding the particular exchange transaction being analyzed. This contention is directly in conflict with the Supreme Court's stated views. Bond discount, as such, is not defined in the Internal Revenue Code nor the Treasury Regulations, and therefore whether it exists or not, as the result of a certain transaction, cannot be determined as a matter of law. Bond discount is a creature of economic fact as clearly recognized by those cases decided by the Supreme Court.

Respondent believes that petitioner's claim that the court of appeals' decision in this case is in conflict with the decisions of other courts is clearly an overstatement.

The cases cited in the Petition, other than those decided by the Court of Claims, clearly reflect unanimity. If the Court of Claims cases are isolated from the remaining body of law on the issues here involved, it is clear that only factual distinctions among the remaining cases, based on the economic facts of the individual transactions analyzed, have caused the numerous remaining decisions to vary to any extent.

Those Court of Claims cases relied upon by petitioner stand alone in their views against a formidable array of cases of the Supreme Court (*United States* v. *Midland-Ross Corp., supra; Helvering* v. *Union Pacific Railroad Co., supra*) and cases from various circuits which uphold in every respect the authoritative and well-reasoned decision of the Court of Appeals for the Tenth Circuit in this case. *Atchison, Topeka and Santa Fe R.R. Co.* v. *United States,* 443 F.2d 147 (10th Cir. 1971); *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962); *Montana Power Co.* v. *United States,* 232 F.2d 541 (3d Cir. 1956); *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883 (3d Cir. 1942); *Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F. Supp. 879 (M.D. Ga. 1955); and *Industrial Development Corp.* v. *United States,* 56-2 U.S.T.C. ¶10066 (N.D. Ill. 1956).

The Court of Claims' decisions actually conflicting with the decision of the Court of Appeals for the Tenth Circuit in this case are *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F.2d 1102 (Ct. Cl. 1971), *cert. denied* 404 U.S. 1017 (1972); *Missouri Pacific R.R. Co.* v. *United States,* 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied* 402 U.S. 944 (1971); and *Erie Lackawanna R.R. Co.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), the former relying on the latter as the basis for their decisions. Although *Texstar Corp.* v. *United States,* 73-1 U.S.T.C. ¶9105 (N.D. Tex. 1972) is mentioned in the Petition as a potentially con-

flicting decision, its value as authority on the issues here is of relatively little significance in view of the fact that whether or not discount existed was left to a jury by the district court.

Claussen's Inc. v. *United States,* 469 F.2d 340 (5th Cir. 1972), another purportedly conflicting decision, was clearly and appropriately distinguished by the Court of Appeals for the Tenth Circuit in its decision, based again on the economic facts of the transaction there involved. The Court of Appeals for the Tenth Circuit stated in its opinion:

> "We are also of the opinion that the case of *Claussen's Inc.* v. *United States,* 5 Cir., 469 F.2d 340 (decided November 16, 1972) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose." (Appendix B, *supra* n.1, p. 65 n.7)

Petitioner has also cited, in footnote 1 on page 6 of the Petition, *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D.N.Y. 1970), *reaffirmed,* 330 F. Supp. 421 (S.D.N.Y. 1971) as a conflicting decision. After the decision in the present case was rendered by the Court of Appeals for the Tenth Circuit, a District Court for New York rendered its decision on the merits in that same case, *Cities Service Co.* v. *United States,* 73-2 U.S.T.C. ¶9495 (S.D.N.Y. June 12, 1973), referring to the decision of the Court of Appeals for

the Tenth Circuit in the case at hand. The district court in the latest *Cities Service* decision chose to look to the economic facts surrounding the similar exchange which took place in that case as the appropriate method to be used in determining the existence and amount of bond discount.

An analysis of the *Erie Lackawanna* case, *supra*, which is the basic conflicting decision cited by the petitioner, indicates it to be clearly erroneous because it is not based on sound reasoning and because it departs completely from the prior decisions of the Supreme Court in that it ignores the economic facts surrounding the exchange transaction which took place in that case.

As stated by Judge Phillips in the Court of Appeals for the Tenth Circuit's opinion in the case at hand:

> "* * * [T]he Court of Claims decisions [*Erie* and *Missouri Pacific*] * * * are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." (Appendix B, *supra* n.1, p. 58)

The essence of Judge Phillips' criticism of the decision in the *Erie* case was that it does not conform to economic and business realities. Economic and business realities dictate that the value in the open market of the preferred stock or old bonds or the like, at the time of an exchange, determines the face amount and interest rate of the debentures which the issuing corporation is willing to issue and the preferred stockholders or old bondholders are willing to accept. If the shoe were on the other foot and the fair market value of the preferred stock was greater, at the time of the proposed exchange, than the proposed face amount of the new debentures, economic and

business realities would likewise have dictated that the preferred stockholders refuse to accept the new debentures in the exchange.

Respondent believes that the decisions of the Supreme Court herein cited and the decisions of the various courts of appeal clearly recognize and stand for the proposition that economic reality necessarily must govern in determining whether bond discount exists in any given case and the amount thereof.

2. Respondent seriously questions the petitioner's claim as to the great administrative importance of the question here involved. The question is very narrow in its scope and far more readily lends itself to congressional legislative action, than it does to resolution by the courts. In this respect, respondent believes that Congress has reviewed the matter recently and has chosen to stand by the previous decisions of the Supreme Court and courts of appeal. If the administrative importance of potential bond discount cases were as great as is now suggested by petitioner, Congress surely would have been aware of it when it thoroughly considered the law, on the subject matter here involved, in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

In the Tax Reform Act of 1969, Congress amended section 1232(b) (2) of the Internal Revenue Code, dealing with the treatment of original issue discount by bondholders. The primary purpose and effect of the amendment was to achieve consistency in treatment between bond issuers and holders in the reporting of discount: holders were required to report discount income ratably over the life of the bond, just as issuers had always ratably amortized discount expense. A secondary purpose was to more clearly define those situations in which bond discount might arise.

The 1969 changes arose at the instance of the Treasury, which made the following proposal:

> "Present concern is also expressed about transactions in which debt is a significant element of the acquisition price. Tax policy should focus on the appropriateness of the interest deduction with respect to the issued debt. It appears, however, that the greatly increased use of debt in recent acquisitions, is motivated primarily by factors other than the desire to obtain an interest deduction for tax purposes. * * *
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> "In addition, we propose that the following immediate steps be taken by legislative action. These steps will impede mergers and acquisitions in which debt securities are used to gain tax advantages. * * *
>
> "(2) To achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount, we recommend that Section 1232 be amended to require that original issue discount be treated as additional interest income to the bondholders to be reported ratably over the life of the bonds." Representatives of the Treasury Department, Tax Reform Proposals Contained in the Message from the President of April 21, 1969, Presented to the Comm. on Ways and Means, 91st Cong., 1st Sess. 46-49 (Comm. print 1969).

The Treasury recognized that a corporation could amortize and deduct discount with respect to bonds issued for stock or securities or other assets. The Treasury did not propose to alter that treatment. It only proposed that the bondholders' treatment be made consistent.

As passed by the House and as reported by the Senate Finance Committee, section 413 of the Act contained the following addition to section 1232(b) (2) of the Code:

> "In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph, issued for property, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property."

In explaining this provision, the House Ways and Means Committee observed:

> "There is some question under present law as to whether the original issue discount rule applies to a bond which is issued for property, such as stock, which has a value below the face amount of the bond.
>
> * * *
>
> "In order to clarify the situations in which original issue discount may arise, the bill further provides that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, or other property (including the assets of another corporation) for the bond." H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 109-110 (1969).

The clarification presumably intended was to provide expressly what the Treasury and the Ways and Means Committee assumed was the sound existing law—that the issuing corporation could deduct and amortize bond discount on bonds issued for stock or securities.[2] It was also

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2. A clarification of existing law by a Committee report is entitled to great respect. Cf. *Commissioner* v. *Bilder*, 369 U.S. 499 (1962).

intended to make the debentureholders' treatment of original issue discount consistent with that of the issuer.

The Senate Finance Committee, after considering the proposed changes, approved the House proposal to clarify the situation in which original issue discount may arise when bonds or evidence of indebtedness are issued for property. S. Rep. No. 91-522, 91st Cong., 1st Sess. 146-148 (1969). The Staff of the Joint Congressional Committee noted that "[t]he bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property." Staffs of Joint Comm. on Internal Revenue Taxation & Comm. of Finance, 91st Cong., 1st Sess., Summary of H.R. 13270, The Tax Reform Act of 1969 (As Passed by the House of Representatives) 61 (Comm. Print 1969).

At the last-minute suggestion of the Treasury, the Bill was modified on the floor of the Senate in two respects: (1) the issue price determined on the basis of the fair market value of the property was limited to situations where either the bonds are traded on an established securities market or the property consists of securities so traded; (2) the definition of issue price was revised so that in the case of a bond or evidence of indebtedness issued pursuant to a plan of reorganization, the issue price would be the stated redemption price at maturity. Parenthetically, this latter provision, which was enacted into law, refers to tax free reorganizations as distinguished from the taxable transaction involved in the case at hand.

In two major respects the legislation discussed above and the Congressional action thereon renders action by the Supreme Court in this case unnecessary on what appears now to be a moot issue. First, Congress has within just four years reviewed in depth the law in this area and has found no necessity for changes other than those then made

which now appear in the law. This recent legislation and the history behind it gives strong support to the decision of the Court of Appeals for the Tenth Circuit in this case which decision conforms to the previous decisions of the Supreme Court and other courts of appeal.

Secondly, with respect to issues of debentures by taxpayers after May 27, 1969, the issues presented in the instant Petition have been disposed of by Congressional action and the questions are moot, a fact recognized by petitioner in the Petition where it is noted that section 1232(b)(2) as amended applies to bonds or evidences of indebtedness issued after May 27, 1969.

The petitioner's additional assertion in the Petition that the Supreme Court should grant certiorari in this case solely because the Internal Revenue Service anticipates a variety of bond discount problems, which are yet undefined, indicates that petitioner may be premature in its request to the Court. Even when these problems mature the cases will have to be decided on the basis of the same principle heretofore pronounced by the Supreme Court, said principle being that the economic facts surrounding an exchange transaction will control in the determination of whether or not bond discount arises. This is the only possible principle which can be developed because bond discount is a creature of economic fact.

CONCLUSION

The Petition for Certiorari should not be granted because the decision of the Court of Appeals for the Tenth Circuit is not in conflict with any decision of this Court or the decisions of the other courts of appeal on the issues presented by the Petition, and the Court of Appeals for the

Tenth Circuit has decided the issues raised entirely in accordance with applicable decisions of this Court and in harmony with well-reasoned decisions of all other courts which have rendered decisions on the issues herein raised.

Respectfully submitted,

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I certify that on the 16th day of August, 1973, a copy of the above and foregoing Brief of Respondent in Opposition to Petition for Writ of Certiorari was sent postage prepaid, by regular United States mail, to the Honorable Robert H. Bork, Solicitor General, Department of Justice, Washington, D.C. 20530, Scott P. Crampton, Assistant Attorney General, Department of Justice, Washington, D.C. 20530, and Meyer Rothwacks and Ernest J. Brown, Attorneys, Department of Justice, Washington, D.C. 20530.

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